REPORT OF THE AUDIT OF THE KENTUCKY LOTTERY CORPORATION

For The Years Ended June 30, 2006 and 2005

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CRIT LUALLEN
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To the People of Kentucky
Honorable Ernie Fletcher, Governor
Honorable David L. Williams, President, Kentucky Senate
Honorable Jody Richards, Speaker, Kentucky House of Representatives
Board of Directors, Kentucky Lottery Corporation

The enclosed report prepared by Harding, Shymanski and Company, P.S.C., Certified Public Accountants and Consultants, presents the financial and compliance audit of the books and records of the Kentucky Lottery Corporation for the years ended June 30, 2006 and 2005, as required by KRS 154A.130.

We engaged Harding, Shymanski and Company PSC to perform the audit in accordance with auditing standards generally accepted in the United States of America. We worked closely with the firm during our report review process.

Respectfully submitted,

Crit Luallen
Auditor of Public Accounts

Enclosure

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KENTUCKY LOTTERY CORPORATION

Financial Report

June 30, 2006

CONTENTS

INDEPENDENT AUDITOR'S REPORT

HARDING SHYMANSKI
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To the Auditor of Public Accounts,
Commonwealth of Kentucky, and
the Board of Directors of the
Kentucky Lottery Corporation

We have audited the accompanying financial statements of the Kentucky Lottery Corporation (the KLC), a component unit of the Commonwealth of Kentucky, as of and for the year ended June 30, 2006 as listed in the table of contents. These financial statements are the responsibility of the KLC's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of the KLC for the year ended June 30, 2005 were audited by other auditors whose report, dated August 19, 2005, expressed an unqualified opinion on those statements.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the KLC as of June 30, 2006, and the result of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The accompanying Management's Discussion and Analysis is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

INDEPENDENT AUDITOR'S REPORT (CONTINUED)

In accordance with *Government Auditing Standards*, we have also issued our report dated August 2, 2006 on our consideration of the KLC's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

Harding, Shymanski & Company, P.S.C.

Louisville, Kentucky
August 2, 2006

Our discussion of the Kentucky Lottery Corporation's (the KLC) financial performance provides an overview of the KLC's financial activities for the fiscal years ended June 30, 2006 and 2005. Please read it in conjunction with the financial statements, which follow.

Financial Highlights

- Operating revenues for 2006 were a record $742.3 million compared to $707.3 million in 2005, an increase of $35 million or five percent.
- Due to lower prize payouts on certain on-line games, gross profit for 2006 was a record $242.9 million compared to $196.4 million in 2005, an increase of $46.5 million, or 23.7 percent.
- Operating expenses in 2006 were 5.5 percent of sales compared to 5.6 percent of sales in 2005.
- Income from operations in 2006 was $202.4 million compared to $157 million in 2005, an increase of $45.4 million, or 28.9 percent.
- Payments to the Commonwealth of Kentucky's KEES/Education programs and the General Fund were a record $204.3 million compared to $158.2 million in 2005, an increase of $46.1 million or 29.1 percent.

Using This Annual Report

The KLC is accounted for as an enterprise fund, reporting on all of the activity's assets and liabilities using the accrual basis of accounting much like a private business activity.

As such, this annual report consists of a series of financial statements, along with explanatory notes to the financial statements and supplemental schedules. The Statements of Net Assets and the Statements of Revenues, Expenses and Changes in Net Assets report the KLC's net assets and changes in them.

To assess the KLC's financial position and financial health, the reader of these statements should pay particular attention to changes in the components of assets and liabilities as set forth on the Statements of Net Assets, and in changes in operating revenues and expenses as set forth in the Statement of Revenues, Expenses and Changes in Net Assets.

Total Assets

Total assets consist primarily of cash and cash equivalents, investments, accounts receivable and capital assets. As shown in Table 1, the KLC's total assets decreased $25.4 million from $276.4 million in 2005 to $251 million in 2006. In 2005, total assets decreased $25.8 million during the year from $302.2 million to $276.4 million. Cash, cash equivalents and investments decreased $24.8 million in 2006 from $234.2 million to $209.4 million and in 2005 decreased $21 million from $255.2 million to $234.2 million. The change in this account is due primarily to an increase or decrease in market value of the KLC's investments and to the fact that there were minimal additions to the pool of installment prizes in 2006 and 2005. Investments consist of U.S. Treasury zero-coupon bonds and other U.S. Government agency securities carried at fair value. Accounts receivable represents revenue to be collected from the sales of on-line and instant game tickets to retailers. Capital assets consist of buildings, game equipment, data processing equipment, etc. utilized by the KLC in the sale of on-line and instant game tickets.

Capital Assets

The KLC's investment in capital assets, net of accumulated depreciation in 2006 and 2005 was $12.4 million and $14.6 million, respectively. The investment in capital assets includes buildings, game equipment, data processing equipment, automobiles, software, and furniture and fixtures. The total decrease in the KLC's investment in capital assets for 2006 was $2.2 million or 15.2 percent compared to a decrease of $1.9 million or 11.5 percent in 2005. The major capital asset events during 2006 and 2005 were the purchase of data processing hardware and software. Additional information on the KLC's capital assets can be found in Note 6 to the financial statements.

Table 1
Net Assets
(in millions)

	2006	2005	% Change	2004
Current and Other Assets	$75.6	$69.0	9.6%	$76.0
Investments	157.7	187.5	-15.9%	203.5
Capital assets, net	12.4	14.6	-15.1%	16.5
Deposits with MUSL	5.3	5.3	0.0%	6.2
Total assets	251.0	276.4	-9.2%	302.2
Current Liabilities	64.1	58.4	9.8%	70.4
Long-term liabilities	150.4	168.8	-10.9%	182.7
Total liabilities	214.5	227.2	-5.6%	253.1
Net Assets				
Invested in capital assets	12.4	14.6	-15.1%	16.5
Unrestricted - accumulated unrealized gains on investments	9.4	22.2	-57.7%	21.7
Unrestricted	14.6	12.4	17.7%	10.9
Total net assets	$36.4	$49.2	-26.0%	$49.1

Liabilities

Table 2
Liabilities
(in millions)

	Current 2006	Current 2005	Current 2004	Long-term 2006	Long-term 2005	Long-term 2004
Prize liabilities	$50.2	$49.5	$48.5	$150.4	$168.8	$182.7
Due to Commonwealth	7.0	2.3	14.3			
Accounts payable and other liabilities	6.9	6.6	7.6			
Total liabilities	$64.1	$58.4	$70.4	$150.4	$168.8	$182.7

Total current liabilities increased $5.7 million or 9.8 percent in 2006 and decreased $12 million or 17.0 percent in 2005. The account titled "Due to Commonwealth" increased $4.7 million in 2006 and decreased $12 million in 2005. This is a timing issue and represents payments due to the General Fund and the KEES Reserve Fund after the fiscal year-end.

Long-term liabilities consist principally of prize liability for prizes paid in installments over several years. Long-term prize liability decreased $18.4 million or 10.9 percent in 2006 and $13.9 million or 7.6 percent in 2005. The decrease is due to the fact that there were only four new winner amounts added to the pool of installment prizes in 2006 and no new additions in 2005. More detailed information can be obtained in Note 7 to the financial statements.

Net Assets

As shown in Table 1, the KLC's net assets in 2006 decreased $12.8 million to $36.4 million. The decrease was attributable to the decrease in market value of investments the KLC holds to fund future payments due on annuitized lottery prizes. Accounting principles dictate the KLC record in its financial records the gain or loss related to the change in market value of these investments. Zero-coupon U.S. government bonds have been purchased for the payment of installment prize awards and are generally held to maturity. The change in the market value of these investments (i.e. the unrealized losses on investments) was recorded as a decrease in unrestricted net assets. The accumulated unrealized gain on investments included in unrestricted net assets at June 30, 2006 is not available for transfer to the Commonwealth's General Fund. The KLC's investment in capital assets, net of related debt, of $12.4 million is also not available for transfer to the Commonwealth's General Fund as these assets are utilized in the KLC's day-to-day operations. The remaining net assets of $14.6 million are unrestricted and are available for transfer to the Commonwealth's General Fund based on the KLC's cash flow and working capital requirements. In 2005, net assets increased $.1 million to $49.2 million. The increase was attributable to the increase in market value of investments the KLC holds to fund future payments due on annuitized lottery prizes. The change in the market value of these investments (i.e. the unrealized gains on investments) was recorded as an increase in unrestricted net assets.

Changes in Net Assets

Table 3
Changes in Net Assets
(in millions)

	2006	2005	2004
Operating revenues			
Instant games	$ 424.9	$ 409.4	$ 385.7
On-line games	317.4	297.9	339.5
Total operating revenues	742.3	707.3	725.2
Nonoperating revenues	1.9	0.7	0.5
Total revenues	744.2	708.0	725.7
Operating expenses			
Direct costs:			
Prize expense	444.9	457.7	439.2
Commissions to retailers	46.7	45.1	45.1
Ticket costs	7.8	8.1	7.6
Total direct costs	499.4	510.9	491.9
Administrative expenses	40.5	39.3	40.4
Total operating expenses	539.9	550.2	532.3
Nonoperating expenses	12.8	-0.5	18.1
Payments to the Commonwealth of KY	204.3	158.2	193.5
Total expenses	757	707.9	743.9
Changes in net assets	($12.8)	$0.1	($18.2)

See Statements of Revenues, Expenses and Changes in Net Assets for items included in each line of Table 3. See Tables 4, 5 and 6 for explanation of differences in the above items for 2006 and 2005.

Sales and Prize Expenses

Sales

Table 4 compares sales, prizes, unclaimed prizes and gross margin (sales minus net prizes) for each lottery game category for fiscal year 2006, fiscal year 2005 and fiscal year 2004. In 2006, the KLC produced record sales of $742.3 million; an increase of $35 million or five percent compared to 2005 and record gross profit margin of $297.4 million, an increase of $47.8 million or 19.1 percent compared to 2005.

Instant tickets are composed of two product categories, Scratch-off tickets and Pull-tab tickets. Scratch-off ticket sales, which accounted for 54.5 percent of all KLC sales, reached an all time high in 2006 at $404.9 million, an increase of $19.8 million or 5.1 percent over 2005. Sales growth within this product category continues to occur at the $5, $10 and $20 price points with increases of $7 million or 6.4 percent, $16.8 million or 35.3 percent and $12 million or 31.5 percent, respectively. The $5, $10 and $20 price points accounted for 56.7 percent of scratch-off sales compare to 50.4 percent in 2005. Sales declines were recognized at the $1 and $2 price point with decreases of $8.7 million or 13.2 percent and $7.2 million or 5.8 percent, respectively. Pull-tab tickets experienced its sixth consecutive annual decline in 2006 with sales of $20 million, a decrease of $4.2 million or 17.4 percent.

In 2005, the KLC produced sales of $707.3 million, a decrease of $18 million or 2.5 percent compared to 2004. Scratch-off ticket sales, which accounted for 54.5 percent of all KLC sales, were $385.1 million, an increase of $28.1 million or 7.9 percent over 2004. Sales growth within this product category was obtained at the $5, $10 and $20 price points with increases of $35.9 million or 49.4 percent, $6.8 million or 16.7 percent and $5.6 million or 17.2 percent, respectively. The $5, $10 and $20 price points accounted for 50.4 percent of Scratch-off ticket sales compare to 40.8 percent in 2004. Sales declines were recognized at the $1 and $2 price point with decreases of $13.1 million or 16.6 percent and $7.1 million or 5.4 percent, respectively. Pull-tab tickets experienced its fifth consecutive annual decline in 2005 with sales of $24.2, a decrease of $4.5 million or 15.6 percent.

Pick 3 and Pick 4 have drawings twice a day Monday through Saturday and once on Sunday. Pick 3 sales for 2006 were $124.3 million, which was $6 million or 4.6 percent less than 2005 and $4.7 million under quota. Pick 3 sales were about 39.2 percent of the 2006 on-line market share compared to 43.8 percent in 2005. Pick 3 sales were impacted by the lack of winning triple-digit combinations. Statistically, triple-digit combinations such as 0-0-0 should be drawn six to seven times per year. In 2006, triple-digit combinations were drawn three times compared to eleven times throughout 2005. Pick 4 achieved record sales in 2006 of $36.6 million, which was $.9 million or 2.5 percent more than 2005 and $1.1 million more than quota. Pick 4 finished the year with about 11.5 percent of the 2006 on-line market share compared to 12 percent in 2005. In 2004, Pick 3 and Pick 4 achieved sales of $130.3 million and $35.7 million, respectively, increases over 2004 of $4.3 million or 3.4 percent and $1.9 million or 5.7 percent, respectively.

The Kentucky Cash Ball product, which was introduced in March 2001, is a "mini-lotto" type game where players pick two sets of numbers for each draw from a matrix of "4 of 33" for the first set and "1 of 31" for the second set. Cash Ball sales for 2006 were $15.6 million, which was $1.3 million or 7.7 percent less than 2005, but $555,000 above quota. Cash Ball sales for 2005 were $16.8 million, which was $3.1 million or 15.4 percent less than 2004 and $2.5 million less than quota.

In September 2001, the KLC introduced Lotto South as a replacement game for Lotto Kentucky. The KLC participates in this game with the Georgia and Virginia lotteries. The increased population base allows for higher and faster growing jackpots than the KLC could generate on its own. Despite those attributes, Lotto South sales continued to decline and the game was ended in February 2006 and replaced with Win for Life. Sales for 2006 and 2005 were $12 million and $17.5 million, respectively.

Table 4
Lottery Sales
(in millions)

	Scratch-off			Pull-tab			Pick 3		
	2006	2005	2004	2006	2005	2004	2006	2005	2004
Sales	$ 404.9	$ 385.1	$ 357.0	$ 20.0	$ 24.2	$ 28.7	$ 124.3	$ 130.3	$ 126.0
Gross Prizes	278.1	263.1	242.8	13.6	17.0	20.1	64.4	90.6	80.4
Less Unclaimed Prizes	(4.4)	(3.1)	(4.9)	(0.2)	(0.2)	(0.2)	(0.9)	(0.9)	(1.0)
Net Prizes	273.7	260.0	237.9	13.4	16.8	19.9	63.5	89.7	79.4
Gross Margin	$ 131.2	$ 125.1	$ 119.1	$ 6.6	$ 7.4	$ 8.8	$ 60.8	$ 40.6	$ 46.6

	Pick 4			Tic Tac Cash / Double Up Cash / Extra			Powerball		
	2006	2005	2004	2006	2005	2004	2006	2005	2004
Sales	$ 36.6	$ 35.7	$ 33.7	$ 4.2	$ 7.1	$ 2.1	$ 117.6	$ 90.5	$ 133.9
Gross Prizes	18.8	23.7	16.5	2.6	4.8	1.4	58.8	45.3	66.1
Less Unclaimed Prizes	(0.5)	(0.4)	(0.3)	(0.1)	(0.1)	(0.1)	(2.6)	(2.5)	(3.9)
Net Prizes	18.3	23.3	16.2	2.5	4.7	1.3	56.2	42.8	62.2
Gross Margin	$ 18.3	$ 12.4	$ 17.5	$ 1.7	$ 2.4	$ 0.8	$ 61.4	$ 47.7	$ 71.7

	KY Cash Ball			Win for Life/Lotto South			Total		
	2006	2005	2004	2006	2005	2004	2006	2005	2004
Sales	$ 15.6	$ 16.9	$ 19.9	$ 19.1	$ 17.5	$ 23.9	$ 742.3	$ 707.3	$ 725.2
Gross Prizes	9.1	10.9	10.9	10.2	10.3	12.4	455.6	465.7	450.6
Less Unclaimed Prizes	(0.5)	(0.3)	(0.4)	(1.5)	(0.5)	(0.6)	(10.7)	(8.0)	(11.4)
Net Prizes	8.6	10.6	10.5	8.7	9.8	11.8	444.9	457.7	439.2
Gross Margin	$ 7.0	$ 6.3	$ 9.4	$ 10.4	$ 7.7	$ 12.1	$ 297.4	$ 249.6	$ 286.0

In 2006, Powerball sales were $117.6 million, an increase of $27.1 million or 29.9 percent compared to 2005 and $27.7 million over quota. Two record setting jackpots of $340 million in October and $365 million in February fuelled the sales increase. Powerball sales accounted for 37.1 percent of on-line sales. In 2005, Powerball sales were $90.5 million, a decrease of $43.4 million or 32.4 percent compared to 2004.

Win for Life was introduced in March 2006, as a replacement game for Lotto South. It is a six number game where players can win $1,000 a week for life. Players pick six numbers from a field of one through 42. The Lottery draws six numbers and an additional number called the Free Ball. Match six of six and the player wins $1,000 week for life. Drawings take place in the evenings every Wednesday and Saturday. In 2006, Win for Life sales were $7.1 million. The game accounted for 2.2 percent of on-line sales.

Tic Tac Cash is an on-line game that was introduced in August 2004. Players pick one number for each square for a total of eight numbers. The center square is free. The board looks like a tic tac toe grid. Players can win up to $25,000 by having eight lines. Drawings are held Monday through Saturday. In 2006, Tic Tac Cash sales were $4.2 million, a decrease of $2.2 million or 34.4 percent when compared to 2005. Tic Tac Cash sales accounted for 1.3 percent of on-line sales in 2006. Sales for 2005 were $6.4 million.

<u>Prize Expense</u>

In general, prize expense by game should increase or decrease from year to year in proportion to the increase or decrease in sales for a particular game. However, except for the instant game product category, prize expense is also impacted by the luck of the draw. Prize expense for the instant game product category is controllable, to a large degree, by printing a predetermined number and value of winning tickets in the production of each instant game. Prize expense for the on-line lottery products is not predetermined. While each of these lottery products is designed to yield a certain ratio of prizes to sales over a large number of drawings, actual prize payout is determined by lottery players' luck in matching the particular set of numbers randomly selected in each drawing for each game. With that background, Table 4 shows the prize payout by lottery product for 2006, 2005 and 2004.

Gross prize expense in 2006 of $455.6 million reflects a 2.2 percent decrease from 2005 gross prize expense of $465.7 million. The decrease in gross prize expense occurred despite an increase in total sales of 5.1 percent. Following is a discussion of notable variances in prize expense within certain product categories.

Within product lines, gross prize expense for the instant games increased 5.7 percent while sales from instant games increased 5.1 percent. This reflects the continuing shift to the higher price points (more $5, $10 and $20 games) as was discussed in the Scratch-off ticket sales. As a rule, games with higher price points payout more in prizes than games with a lower price point.

Gross prize expense for on-line games decreased 11.7 percent, while sales from on-line games increased 6.5 percent. KY Cash Ball gross prize decreased 16.7 percent while sales decreased 7.4 percent. Gross prize expense for Pick 3 decreased 28.9 percent compared with a 4.6 percent decrease in Pick 3 sales. Gross prize expense for Pick 4 decreased 20.7 percent compared with a 2.6 percent increase in Pick 4 sales. The difference for these three games is due to players not being as lucky in 2006 in matching the random numbers selected for each drawing.

Net prize expense in 2006 was $444.9 million or 60 percent of sales compared to $457.7 million or 64.7 percent of sales in 2005. Unclaimed prizes in 2006 were $10.7 million compared to $8 million in 2005.

In 2005, gross prize expense of $465.7 million reflects a 3.4 percent increase from 2004 gross prize expense of $450.6 million. The increase in gross prize expense occurred despite a decline in total sales of 2.5 percent. Following is a discussion of notable variances in prize expense within certain product categories.

Within product lines, gross prize expense for the instant games increased 6.5 percent while sales from instant games increased 6.1 percent. This reflects the continuing shift to the higher price points (more $5, $10 and $20 games) as was discussed in the Scratch-off ticket sales.

Gross prize expense for on-line games increased 1.1 percent, while sales from on-line games decreased 12.3 percent. KY Cash Ball gross prize expense was unchanged while sales decreased 15.4 percent. Gross prize expense for Pick 3 increased 12.7 percent compared with a 3.4 percent increase in Pick 3 sales. Gross prize expense for Pick 4 increased 43.6 percent compared with a 5.7 percent increase in Pick 4 sales. The difference for these three games is due to players' overall greater luck in 2005 in matching the random numbers selected for each drawing. Lotto South gross prize expense decreased 16.9 percent but sales decreased 26.6 percent.

Net prize expense in 2005 was $457.7 million or 64.7 percent of sales compared to $439.2 million or 60.6 percent of sales in 2004. Unclaimed prizes in 2005 were $8 million compared to $11.4 million in 2004.

Other Expenses

Table 5
Commissions, Operating, and Other Expenses
(in millions)

	2006	2005	% Change	2004
Retailer commissions	$ 46.7	$ 45.1	3.5%	$ 45.1
Ticket costs	$ 7.8	$ 8.1	-3.7%	$ 7.6
Operating expenses	$ 40.5	$ 39.3	3.1%	$ 40.4
Amortization of prize discount	$ 11.7	$ 13.4	-12.7%	$ 14.4

Retailer commissions cover base selling and cashing commissions as well as a retailer incentive plan based on the sale of instant tickets. Retailer commissions for 2006 and 2005 were 6.3 percent and 6.4 percent of sales. Ticket costs include the cost to produce and ship instant tickets. Ticket costs for 2006 and 2005 were one percent and 1.1 percent, respectively. Operating expenses increased $1.2 million from 2005, but dropped to 5.5 percent of sales. In 2005, operating expenses were 5.6 percent of sales.

Amortization of prize discount, which reflects the periodic write-off of the difference between the present value of installment prizes and the face value of said prizes, decreased $1.7 million in 2006 and $1 million in 2005.

Other Revenues

Table 6
Other Revenues
(in millions)

	2006	2005	% Change	2004
Increase (decrease) in fair value of investments	$ (1.1)	$ 13.9	-107.9%	$ (3.7)
Interest income	$ 1.7	$ 0.5	240.0%	$ 0.3
Other miscellaneous revenue	$ 0.2	$ 0.2	0.0%	$ 0.2

Increase or decrease in fair value of investments represents the change in market value of the KLC's investments held to fund prize installments. Since the KLC typically holds its investments to maturity to provide a secure funding vehicle for future prize payments, gain or loss in market value does not affect ongoing operations.

Interest income consists principally of interest on the KLC's cash balance, which is invested in short-term investments. The increase in interest income reflects the federal government's policy to raise short-term interest rates in 2006, a trend that started in 2005.

Miscellaneous revenues consist primarily of various fees assessed to retailers and income earned from a security-lending program.

Payments to the Commonwealth of Kentucky

In 2006 and 2005, payments to the Commonwealth of Kentucky (Commonwealth) represent a transfer of funds from the KLC to the Commonwealth's general fund and the KEES Program Reserve Account. Payments to the general fund, which are approved by the Board of Directors and remitted to the Commonwealth on a monthly basis, are appropriated by the General Assembly to provide funding for postsecondary education and literacy development. Payments to the KEES Reserve Account are used to provide funding for postsecondary education. Payments to the Commonwealth in 2006 were a record $204.3 million, an increase of $46.1 million or 29.1 percent over 2005. Payments in 2005 were $158.2 million, a decrease of $35.3 million or 18.2 percent from 2004.

Currently Known Facts, Decisions, or Conditions

The Indiana Gaming Commission has issued a gaming license for a boat in Orange County, which is 50 miles from downtown Louisville, Kentucky. The riverboat is scheduled to begin operations in fiscal year 2007. In order to increase on-line sales, the Corporation is planning to offer a new on-line game in the third quarter of fiscal year 2007.

Contacting the KLC's Financial Management

This financial report is designed to provide the public and other interested parties with an overview of the financial results of the KLC's activities, and to show the KLC's accountability for the revenue that it generates. If you have any questions about this report or need additional financial information, contact the Chief Financial Officer at the Kentucky Lottery Corporation, 1011 West Main Street, Louisville, Kentucky 40202.

KENTUCKY LOTTERY CORPORATION

STATEMENTS OF NET ASSETS
June 30, 2006 and 2005
(dollars in thousands)

	2006	2005
ASSETS		
Current Assets		
Cash and equivalents	**22,299**	18,983
Investments at fair value, current portion	**29,451**	27,651
Accounts receivable, net	**23,102**	21,623
Ticket inventories	**95**	152
Other	**700**	560
Total current assets	**75,647**	68,969
Noncurrent Assets		
Investments at fair value, less current portion	**157,676**	187,549
Capital assets, net	**12,377**	14,601
Deposits with Multi-State Lottery Association	**5,291**	5,358
Total noncurrent assets	**175,344**	207,508
Total assets	**250,991**	276,477
LIABILITIES		
Current Liabilities		
Accounts payable and accrued expenses	**6,928**	6,611
Due to Commonwealth	**6,969**	2,328
Estimated prize liability, current portion	**50,241**	49,536
Total current liabilities	**64,138**	58,475
Noncurrent Liabilities		
Estimated prize liability, less current portion	**150,423**	168,769
Total liabilities	**214,561**	227,244
NET ASSETS		
Invested in capital assets	**12,377**	14,601
Unrestricted	**24,053**	34,632
Total net assets	**$ 36,430**	$ 49,233

See accompanying notes.

KENTUCKY LOTTERY CORPORATION

STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS
For the Years Ended June 30, 2006 and 2005
(dollars in thousands)

	2006	2005
Operating revenues		
Instant games	**424,938**	409,350
On-line games	**317,374**	297,910
Total operating revenues	**742,312**	707,260
Direct costs		
Prize expense		
Instant games	**287,014**	276,769
On-line games	**157,933**	180,924
Total prize expense	**444,947**	457,693
Commissions to retailers	**46,718**	45,129
Ticket costs	**7,772**	8,053
Total direct costs	**499,437**	510,875
Gross profit	**242,875**	196,385
Operating expenses		
Advertising and promotion	**10,476**	9,984
Salaries, wages and benefits	**13,042**	12,716
Contracted and professional services	**11,161**	10,808
Depreciation	**3,217**	3,233
Other general and administrative	**2,609**	2,601
Total operating expenses	**40,505**	39,342
Operating income	**202,370**	157,043
Nonoperating income (expense)		
Payments to the Commonwealth of Kentucky	**(204,318)**	(158,187)
Investment income	**639**	14,413
Interest expense	**(11,703)**	(13,404)
Other income	**209**	220
Total nonoperating income (expense)	**(215,173)**	(156,958)
Increase (decrease) in net assets	**(12,803)**	85
Net assets, beginning of year	**49,233**	49,148
Net assets, end of year	**$ 36,430**	$ 49,233

See accompanying notes.

KENTUCKY LOTTERY CORPORATION

STATEMENTS OF CASH FLOWS
For the Years Ended June 30, 2006 and 2005
(dollars in thousands)

	2006	2005
Cash flows from operating activities		
Cash received from customers	**$ 740,833**	$ 708,893
Cash payments to prize winners and suppliers	**(540,733)**	(548,045)
Cash payments to employees for services	**(13,428)**	(12,565)
Net cash provided by operating activities	**186,672**	148,283
Cash flows from noncapital financing activities		
Payments to the Commonwealth of Kentucky	**(199,677)**	(170,120)
Cash flows from capital and related financing activities		
Purchases of capital assets	**(994)**	(1,400)
Proceeds from disposal of capital assets	**30**	61
Net cash used in capital and related financing activities	**(964)**	(1,339)
Cash flows from investing activities		
Proceeds from sale of investments	**18,822**	17,136
Purchase of investments	**(3,344)**	(573)
Deposits with Multi-State Lottery Association	**67**	886
Investment income	**1,740**	551
Net cash provided by investing activities	**17,285**	18,000
Net increase (decrease) in cash and cash equivalents	**3,316**	(5,176)
Cash and equivalents at beginning of year	**18,983**	24,159
Cash and equivalents at end of year	**$ 22,299**	$ 18,983

See accompanying notes.

KENTUCKY LOTTERY CORPORATION

STATEMENTS OF CASH FLOWS (CONTINUED)
For the Years Ended June 30, 2006 and 2005
(dollars in thousands)

	2006	2005
Reconciliation of operating income to net cash provided by operating activities		
Operating income	**$ 202,370**	$ 157,043
Adjustments to reconcile operating income to net cash provided by operating activities		
Depreciation	**3,217**	3,233
Provision for losses on accounts receivable	**129**	0
Gain on disposition of assets	**(29)**	0
Increase (decrease) in cash due to changes in		
Accounts receivable, net	**(1,608)**	1,633
Ticket inventories	**57**	188
Other assets	**(140)**	74
Accounts payable and accrued expenses	**317**	(989)
Estimated prize liability	**(17,641)**	(12,899)
Total adjustments	**(15,698)**	(8,760)
Net cash provided by operating activities	**$ 186,672**	$ 148,283

Noncash capital and investing activities:

The accretion of interest on investments held to fund grand prizes, which increased prize liability for the years ended June 30, 2006 and 2005 totaled $11,703 and $13,404, respectively.

The fair value of investments decreased $12,803 in 2006 and increased $457 in 2005.

See accompanying notes.

Note 1 – Organization

The Kentucky Lottery Corporation (the KLC) was created with the enactment of House Bill No. 1 in December 1988 as an independent de jure municipal corporation and political subdivision of the Commonwealth of Kentucky (the Commonwealth). The KLC is to be managed in such a manner that enables the people of the Commonwealth to benefit from its profits and to enjoy the best possible lottery games. The operations of the KLC are separate and distinct from other operations of the Commonwealth.

The KLC commenced operations on April 4, 1989 with the sale of instant game tickets. Sales of on-line games began October 16, 1989. In January 1991, the KLC joined the Multi-State Lottery Association, a group of states that combine lottery sales for on-line games.

Note 2 – Summary of Significant Accounting Policies

Reporting Entity

The KLC has adopted the provisions of Government Accounting Standards Board (GASB) Statement No. 14, *The Financial Reporting Entity*, under which the financial statements include all the organizations, activities, functions and component units for which the KLC is financially accountable. Financial accountability is defined as the appointment of a voting majority of the component unit's board, and either (1) the KLC's ability to impose its will over the component unit, or (2) the possibility that the component unit will provide a financial benefit to or impose a financial burden on the KLC.

The KLC has determined that no outside agency meets the above criteria and, therefore, no other agency has been included as a component unit in the KLC's financial statements. In addition, since the KLC provides a financial benefit for the Commonwealth, the KLC is part of the reporting entity of the Commonwealth and is, therefore, included in the Commonwealth's Annual Financial Report as a blended component unit. The accompanying financial statements are not intended to present the financial position or the results of operations and cash flows of the Commonwealth of Kentucky or its proprietary funds.

Note 2 – Summary of Significant Accounting Policies (Continued)

Basis of Presentation

The KLC is accounted for as an enterprise fund. The financial statements are prepared on the accrual basis of accounting in accordance with accounting principles generally accepted in the United States of America. The KLC has elected to apply all applicable GASB pronouncements as well as Financial Accounting Standards Board (FASB) pronouncements and Accounting Principles Board (APB) opinions issued on or before November 30, 1989, unless those pronouncements conflict with or contradict GASB pronouncements. The KLC has further elected not to apply FASB pronouncements issued after November 30, 1989, in accordance with GASB Statement No. 20.

As an enterprise fund, the KLC distinguishes *operating* revenues and expenses from *nonoperating* items. Operating revenues and expenses generally result from providing services and delivering goods in connection with the KLC's principal ongoing operations. The principal operating revenues of the KLC are charges to customers for sales of lottery products. Operating expenses include the cost of sales and services, selling and administrative expenses, and depreciation on capital assets. All revenues and expenses not meeting this definition are reported as nonoperating revenues and expenses.

Revenue and Accounts Receivable Recognition

Revenue and accounts receivable for on-line games are recognized when tickets are sold to the public by contracted retailers.

Revenue and accounts receivable for instant games are recognized upon activation or issuance of tickets for sale by the retailers, or 50 days from the date of issuance of the tickets to the retailers, whichever is sooner.

Allowance for Doubtful Accounts

The KLC uses the allowance method to account for uncollectible accounts receivable. Trade receivables are written-off when deemed uncollectible. Recoveries of trade receivables previously written-off are recorded when received. KLC wrote off $129,416 for the year ended June 30, 2006. There was nothing written-off for the year ended June 30, 2005. A trade receivable is considered uncollectible after 30 days.

Note 2 – Summary of Significant Accounting Policies (Continued)

Prizes

Prize expense for instant ticket games is recorded as an estimate at the time the related revenue is recognized based on the predetermined prize structure for each game; periodically, the prize expense is adjusted to reflect amounts actually won. Prize expense for on-line games is recorded at the time the related revenue is recognized based on the known prize payout structure. Grand prizes are awarded related to the Lotto South and Powerball on-line games.

Lotto South grand prizes are paid in 30 equal annual installments or in a single lump-sum payment equal to the estimated present cash value of 30 annual payments. The KLC recognizes Lotto South prize expense at the time the related revenue is recognized based on the known prize payout structure. A portion of Lotto South sales of the KLC is remitted to the Virginia State Lottery, the designated administrator for Lotto South, to fund prize payments. All Lotto South grand prizes for winners electing annual installments are funded through the purchase of U.S. Government agency securities. The Party Lottery which sold the grand prize winning ticket has the first option of purchasing the investments, but may defer the purchase to another Party Lottery.

Win for Life grand prizes are paid in weekly installments of $1,000 for the life of a winner. The KLC recognizes Win for Life prize expense at the time the related revenue is recognized based on the known prize payout structure. A portion of the Win for Life sales of the KLC is remitted to the Virginia State Lottery, the designated administrator for Win for Life, to fund prize payments. All Win for Life grand prizes are funded through the purchase of U.S. Government agency securities. The Party Lottery which sold the grand prize winning ticket has the first option of purchasing the investments, but may defer the purchase to another Party Lottery.

Powerball grand prizes are paid in thirty equal annual installments or in a single lump-sum payment equal to the estimated present cash value of thirty annual payments. The KLC recognizes Powerball prize expense at the time the related revenue is recognized based on the known prize payout structure. A portion of Powerball sales of the KLC is remitted to the Multi-State Lottery Association (MUSL) to fund prize payments. MUSL purchases U.S. Government agency securities to fund prize liability to Powerball winners electing annual installments.

Cash and Equivalents

For financial statement purposes, the KLC considers all highly liquid investments with an original maturity of three months or less to be cash equivalents.

Note 2 – Summary of Significant Accounting Policies (Continued)

Investments

Investments consist of U.S. Treasury zero-coupon bonds and other U.S. Government agency securities carried at fair value in accordance with GASB Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools.* Fair value of investments is based on quoted market prices. Investments are in U.S. Treasury zero-coupon bonds and are purchased to meet future installment payments to grand prize winners. There are generally no realized gains or losses on investments, as it is the KLC's policy to hold the investments to maturity.

Ticket Inventories:

Inventories are carried at cost (as determined by the specific identification method) and consist of Pull-tab tickets and instant tickets located in the KLC's warehouses or held by retailers. The cost of tickets is charged to operations upon the recognition of revenue under the procedures described above.

Capital Assets:

Capital assets are carried at cost less accumulated depreciation. The KLC defines capital assets as assets with an initial, individual cost of more than $500 and an estimated useful life in excess of one year. Depreciation is computed using the straight-line method over estimated lives of the assets. When assets are retired or otherwise disposed of, the cost and related accumulated depreciation are removed from the accounts and any resulting gain or loss is reflected in operations in the period of disposal. The estimated useful lives by general classification are as follows:

	Years
Buildings and improvements	30
Machinery and equipment	5 - 15
Vehicles	3 - 5
Computer software	3

Amortization of leasehold improvements is computed using the straight-line method over lease terms of three to five years. Interest related to construction of capital assets is capitalized. No interest was capitalized for the years ended June 30, 2006 and 2005.

Note 2 – Summary of Significant Accounting Policies (Continued)

Deposits with Multi-State Lottery Association (MUSL)

Deposits are carried at cost. MUSL is an unincorporated government-benefit voluntary association created for the purpose of administering joint lottery games, such as Powerball and Instant Powerball TV Game Show. MUSL currently includes 29 state lottery entities, the District of Columbia and the U.S. Virgin Islands. The chief executive officer of each member lottery serves on the MUSL board of directors. As a member of MUSL, the KLC is required to contribute to various prize reserve funds maintained by MUSL. The prize reserve funds serve as a contingency reserve to protect MUSL from unforeseen prize liabilities. All prize reserve funds remitted, and the related interest earnings, will be returned to the KLC upon leaving MUSL, less any portion of unanticipated prize claims which may have been paid from the fund.

Compensated Absences

It is the KLC's policy to permit employees to accumulate earned but unused vacation and sick pay benefits. There is no liability recorded for unpaid accumulated sick leave since the KLC does not have a policy to pay unused amounts when employees separate from service. All vacation pay is accrued when incurred. Accrued vacation totalling approximately $888,000 and $802,000, as of June 30, 2006 and 2005, respectively, is included in accrued expenses in the accompanying statements of net assets.

Estimated Prize Liability

A liability for grand prize winners electing equal annual installments is recorded based on the cost of U.S. Treasury zero-coupon bonds and other U.S. Government agency securities purchased to fund the liability, adjusted for the accretion of interest based upon the purchased yield and maturity date. The estimated prize liability is presented in the statement of net assets net of this imputed interest. Imputed interest is amortized to interest expense over the life of the annuity utilizing the effective interest method.

Net Assets

Net assets of the KLC are classified and displayed as three components:

a. Invested in capital assets - Consists of capital assets, including restricted capital assets, net of accumulated depreciation and reduced by the outstanding balances of any bonds, mortgages, notes, or other borrowings that are attributable to the acquisition, construction or improvement of those assets.
b. Restricted net assets - Consists of assets with constraints placed on the use either by (1) external groups such as creditors, grantors, contributors, or laws or regulations of other governments; or (2) law through constitutional provisions or enabling legislation.
c. Unrestricted net assets - All other net assets that do not meet the definition of "Invested in capital assets, net of related debt" or "restricted".

As of June 30, 2006 and 2005 the KLC had no restricted net assets.

Note 2 – Summary of Significant Accounting Policies (Continued)

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the dates of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Accordingly, actual results could differ from those estimates.

Note 3 – Cash Deposits

All of the KLC's deposits are either insured or collateralized. All deposits exceeding the federal depository insurance coverage level are collateralized with securities held by the KLC's agents in the KLC's name. The KLC's policy regarding custodial credit risk for deposits is for all overnight repurchase agreements to be fully collateralized by U.S. government securities held by the KLC or by the KLC's agent in the KLC's name.

The KLC had deposits with financial institutions at June 30, 2006 and 2005 of approximately $113,000 and $97,000, respectively, which are fully covered by federal depository insurance. Also included in cash and cash equivalents at June 30, 2006 and 2005 are overnight repurchase agreements of $23,027,000 and $13,484,000, respectively.

Note 4 – Investments

At June 30, 2006, the KLC's investment balances were as follows (in thousands):

Investment Type	Fair Value	Maturity	Rating
US Treasuries	$ 78,264	Weighted average maturity of 3.47 years	AAA
Other US Government backed	108,863	Weighted average maturity of 4.76 years	AAA
Total	$ 187,127		

Interest Rate Risk – The KLC has a formal investment policy that limits investment maturities as a means of managing its exposure to fair value losses arising from increasing interest rates. It is the policy of the KLC to hold investments to maturity.

Credit Risk – The KLC only invests in US Treasuries or other debt securities backed by the U.S. Government.

Concentration of Credit Risk – The KLC places no limit on the amount the KLC may invest in any one issuer.

Note 4 – Investments (Continued)

At June 30, 2005, the KLC's investment balances were as follows:

Investment Type	Fair Value
US Treasuries	$ 91,069
Other US Government backed	124,131
Total	$ 215,200

The net increase (decrease) in the fair value of investments includes all changes in fair value that occurred during the year. The components of investment income for the years ended June 30, 2006 and 2005 consisted of the following (in thousands):

	2006	2005
Net increase (decrease) in fair value of investments	$ (1,100)	$ 13,861
Interest income	1,739	550
Security lending income	0	2
Total investment income	$ 639	$ 14,413

When compared to the historical cost method, recording investments at fair value results in a reduction of income of approximately $12,803,000 in 2006 and an increase of income of approximately $457,000 in 2005.

Unrealized gains accumulated in unrestricted net assets at June 30 are as follows (in thousands):

	2006	2005
Unrestricted net assets excluding unrealized gains on investments	$ 15,222	$ 12,426
Unrealized gains on investments	8,831	22,206
Total unrestricted net assets	$ 24,053	$ 34,632

The KLC is authorized by state statutes and investment policies approved by the Board of Directors to lend its investment securities. The lending is managed by the KLC's custodial bank. All loans can be terminated on demand by either the KLC or the borrowers, although the average term of loans is approximately one week. The custodial bank and its affiliates are prohibited from borrowing the KLC's securities.

Note 5 – Accounts Receivable

Accounts receivable at June 30 consisted of the following (in thousands):

	2006	2005
Accounts receivable	23,376	21,954
Allowance for doubtful accounts	(274)	(331)
Accounts receivable, net	$ 23,102	$ 21,623

Note 6 – Capital Assets

Capital asset activity for the year ended June 30, 2006 was as follows (in thousands):

	Beginning Balance	Increases	Decreases	Ending Balance
Capital assets not being depreciated:				
Land	$ 423	$ -	$ -	$ 423
Capital assets being depreciated:				
Buildings	7,206	25	0	7,231
Leasehold improvements	354	19	0	373
Game equipment	10,238	256	(271)	10,223
Data processing equipment	24,816	522	0	25,338
Automobiles, furniture and fixtures	3,740	172	(161)	3,751
Total other capital assets at cost	46,354	994	(432)	46,916
Less accumulated depreciation for:				
Buildings	(1,849)	(241)	0	(2,090)
Leasehold improvements	(331)	(9)	0	(340)
Game equipment	(9,434)	(283)	270	(9,447)
Data processing equipment	(17,427)	(2,355)	0	(19,782)
Automobiles, furniture and fixtures	(3,135)	(329)	161	(3,303)
Total accumulated depreciation	(32,176)	(3,217)	431	(34,962)
Other capital assets, net	14,178	(2,223)	(1)	11,954
Net capital assets	$ 14,601	$ (2,223)	$ (1)	$ 12,377

Note 6 – Capital Assets (Continued)

Capital asset activity for the year ended June 30, 2005 was as follows (in thousands):

	Beginning Balance	Increases	Decreases	Ending Balance
Capital assets not being depreciated:				
Land	$ 423	$ -	$ -	$ 423
Capital assets being depreciated:				
Buildings	7,203	3	0	7,206
Leasehold improvements	333	21	0	354
Game equipment	10,235	3	0	10,238
Data processing equipment	24,199	846	(229)	24,816
Automobiles, furniture and fixtures	3,663	468	(391)	3,740
Total other capital assets at cost	45,633	1,341	(620)	46,354
Less accumulated depreciation for:				
Buildings	(1,609)	(240)	0	(1,849)
Leasehold improvements	(328)	(3)	0	(331)
Game equipment	(9,022)	(412)	0	(9,434)
Data processing equipment	(15,396)	(2,260)	229	(17,427)
Automobiles, furniture and fixtures	(3,205)	(318)	388	(3,135)
Total accumulated depreciation	(29,560)	(3,233)	617	(32,176)
Other capital assets, net	16,073	(1,892)	(3)	14,178
Net capital assets	$ 16,496	$ (1,892)	$ (3)	$ 14,601

Note 7 – Estimated Prize Liability

Estimated prize liability at June 30 consisted of the following (in thousands):

	2006	2005
Current:		
Grand prizes	$ 30,323	$ 29,898
Other prizes	19,918	19,638
Total current portion	$ 50,241	$ 49,536
Long-term:		
Grand prizes	$150,423	$168,769

Long-term liability activity of grand prize awards payable was as follows (in thousands):

Years Ending June 30,	Beginning Balance	Increases	Decreases	Ending Balance
2006	$ 198,667	$ 11,703	$(29,624)	$ 180,746
2005	$ 212,519	$ 13,403	$(27,255)	$ 198,667

Note 7 – Estimated Prize Liability (Continued)

Liabilities for future payments of grand prize liabilities are summarized as follows (in thousands):

Years Ending June 30,	
2007	$ 30,323
2008	31,147
2009	29,501
2010	27,977
2011	27,171
2012 through 2016	71,213
2017 through 2021	10,888
2022 through 2026	5,326
2026 through 2029	676
Total	234,222
Less unamortized discount	(53,476)
Total at present value	180,746
Less current portion	(30,323)
Total long term portion at present value	$150,423

Estimated prize liability for grand prizes is based on the cost of U.S. Treasury zero-coupon bonds and other U.S. Government agency securities purchased to fund the liability, adjusted for the accretion of interest based upon the purchased yield and maturity date. This adjustment of approximately $11,703,000 and $13,404,000 in 2006 and 2005, respectively, is included in interest expense. These amounts comprise the entire amounts of interest expense for the years ended June 30, 2006 and 2005.

Note 8 – Retirement Plan

The KLC has a defined contribution retirement plan (the Plan) which covers all full-time employees. Under the terms of the Plan, the KLC and employees each contribute 6.2 percent of the employee's earned annual base salary, as defined. Employees become eligible for participation and are fully vested at the date of employment for this portion of the Plan.

The KLC also makes a contribution equal to eight percent of the employee's earned annual base salary. For this portion, employees hired prior to October 1, 1993 became eligible at the date of employment and are fully vested providing participation requirements are met. Employees hired after September 30, 1993 become eligible one year after the date of employment and are fully vested after five years of service providing participation requirements are met.

For 2006 and 2005, total payroll was approximately $ 10,027,000 and $9,673,000, respectively. During 2006 and 2005, the KLC's contributions were calculated using the base salary amount for full-time employees of $9,749,000 and $9,064,000, respectively, for the 6.2 percent employer match contribution, and $9,996,000 and $9,230,000, respectively, for the eight percent additional employer contribution. Employer requirements and contributions actually made to the Plan were approximately $1,407,000 and $1,300,000 (14.4 percent and 15.1 percent and of covered payroll) and employee contributions to the Plan were approximately $608,000 and $562,000 (6.20 percent of covered payroll) in 2006 and 2005, respectively.

In addition to the Plan, the KLC's employees are also eligible to participate in two deferred compensation plans sponsored by the Commonwealth of Kentucky. These plans are organized as a Section 457 plan and as a Section 401(k) plan under the Internal Revenue Code. Both plans permit employees to defer a portion of their salary until future years. Deferred compensation is not available to employees until termination, retirement, death, or financial hardship. The Commonwealth of Kentucky's Comprehensive Annual Financial reports should be referred to for further disclosures related to the deferred compensation plans.

Note 9 – Leases

The KLC has entered into operating leases for the rental of office equipment and office and warehouse space under initial lease terms of one to five years.

Approximate minimum rental payments are (in thousands):

Years Ending June 30,	
2007	$ 219
2008	181
2009	122
2010	12
2011	0
Total	$ 534

Total rental expense for 2006 and 2005 was approximately $576,000 and $715,000, respectively.

Note 10 – Payments to the Commonwealth of Kentucky

Payments to the Commonwealth represent transfers of funds from the KLC to the Commonwealth's General Fund and the KEES Program Reserve Account. The payments to the General Fund, which are approved by the Board of Directors and remitted to the Commonwealth on a monthly basis, are used to benefit all Kentuckians. The payments to the KEES Program Reserve Account are used to provide college or technical school scholarships to Kentucky high school students. The amounts payable to the KEES Program Reserve Account result from unclaimed prizes on instant and on-line games. Prizes not claimed within 180 days of drawing date for on-line games or game ending date for instant tickets are forfeited and considered unclaimed. In accordance with Kentucky Revised Statute (KRS) 154A.110(3), any unclaimed prize money from these games may be retained by the KLC and added to the pool from which future prizes are to be awarded or used for special prize promotions, or may be appropriated by the General Assembly directly from the KLC for any public purpose. During the years ended June 30, 2006 and 2005, all unclaimed prize money was transferred to the KEES Program Reserve Account as required by General Assembly House Bill 04HB395. Payments are made as necessary at the end of each quarter.

Note 10 – Payments to the Commonwealth of Kentucky (Continued)

Payments to the Commonwealth for the years ended June 30, 2006 and 2005 included payments to the following funds (in thousands):

	2006	2005
General fund	$ 193,625	$ 150,200
KEES scholarship reserve fund	10,693	7,987
	$ 204,318	$ 158,187

Note 11 – Risk Management

The KLC is exposed to various risks of loss related to torts; theft of, damage to, and the destruction of assets; errors and omissions; injuries to employees; and natural disasters. The KLC has purchased commercial insurance to cover these risks except for workers' compensation and damage to buildings and personal property for which the KLC utilizes the Commonwealth's Risk Management Fund to cover the exposure to these potential losses. The Commonwealth's Comprehensive Annual Financial Reports should be referred to for additional disclosures related to the Risk Management Fund. The KLC also retains risk of loss for the value of certain gaming equipment located at retail establishments. As of June 30, 2006 there were no outstanding liabilities or unpaid claims regarding this gaming equipment. The amount of commercial coverage has not decreased nor has the amount of settlements exceeded coverage in any of the past three fiscal years.

Note 12 – Commitments and Contingencies

In February 2004, a Jefferson Circuit Court jury awarded $2.8 million to the plaintiffs in a suit filed against the KLC. The suit included a Kentucky Civil Rights Act claim. The KLC filed an appeal in May 2004 and intends to continue to defend this action. If a liability is ultimately determined to exist the KLC has insurance coverage in place that would cover a significant portion, if not all, of any such liability. The ultimate outcome of this matter cannot be determined at this time, and as such, any potential adjustments to the financial statements are unknown.

Note 12 – Commitments and Contingencies (Continued)

In December 2002, a Jefferson Circuit Court jury awarded $4.3 million to the plaintiffs in a suit filed against the KLC. The suit included a retaliatory discharge claim under the Kentucky Civil Rights Act, a common law wrongful termination claim and a defamation claim. Upon a motion filed by the KLC, the Circuit Court vacated the jury verdict and ordered a new trial for a determination of liability and damages as to the defamation claim and for a determination of damages only as to the retaliatory discharge claim. The liability verdict on the retaliatory discharge claim was allowed to stand. The common law claim was dismissed. The new trial was held in August 2004 and a Jefferson Circuit Court jury awarded approximately $250,000 to the plaintiffs for damages on the retaliatory discharge claim. There was no finding of liability for the defamation claim. The trial court subsequently allowed the plaintiffs to recover approximately $210,000 for attorneys' fees. The plaintiffs subsequently appealed the trial court's decision to order a new trial, as well as the trial court's decision for the amount of recovery the plaintiffs' attorneys' fees. Seneca Insurance Company has defended the action on behalf of the KLC. The KLC intends to continue to defend this action vigorously. If liability is ultimately determined to exist, the insurance coverage provided by Seneca should cover a significant portion, if not all, of any such liability. The ultimate outcome of this matter cannot be determined at this time, and as such, any potential adjustments to the financial statements are unknown.

In 2003, three actions were filed in the Jefferson Circuit Court against the KLC regarding Extra Cash, a game which was offered in connection with two KLC on-line games, Pick 3 and Pick 4. In all three actions, the plaintiffs allege that the advertising for the Pick 3 and Pick 4 Extra Cash games is false and misleading. In 2005, an action was filed against the KLC by a plaintiff alleging that the KLC engaged in false advertising in connection with a scratch-off game known as Kentucky Millionaire. In all four cases, the plaintiffs seek compensatory and punitive damages. Discovery is ongoing, and no trial date has been set. Unless punitive damages can be recovered, the exposure for each individual plaintiff's claim in these cases is not likely to be material. The most any of these plaintiffs have claimed that they spent on tickets is no more than several hundred dollars. However, the same attorney represents the plaintiffs in two of the Extra Cash cases and in the Kentucky Millionaire case, and in each of these cases, a class has been alleged. In May 2006, the attorney filed a motion to certify a class in one of the Extra Cash cases. A hearing was set for August 14, 2006. If the motion is granted, and a class is certified, the three Extra Cash cases would be consolidated and, because the class likely would be of all Extra Cash players, the exposure to the KLC would increase materially. The type and extent of damages possible is unknown, but could be material. Also, any such decision would serve as a precedent for certifying a class in the Kentucky Millionaire case as well, with the same result. It should be noted that the KLC has defended against the motion to certify by advising the court that a majority of courts that have considered the question have decided that it is not appropriate to certify a class of lottery players. Of course, law from other jurisdictions is not controlling upon Kentucky courts.

From time to time, the KLC is party to lawsuits and claims arising in the normal course of business. The KLC has defended and intends to continue to defend these actions vigorously and believes, based on currently available information, settlements, if any, will not be material to the financial statements.

Note 12 – Commitments and Contingencies (Continued)

The KLC has entered into long term contracts with certain significant vendors related to providing instant tickets and on-line data processing services in support of the KLC's gaming operations. The on-line data processing contract expires June 27, 2008. The total amount to be paid on the on-line data processing is based on a percentage of revenue with no limit. The instant ticket contracts expired September 30, 2005. The KLC Board approved an extension of these contracts to September 30, 2009. The total amount to be paid on the instant ticket contracts is based on a percentage of revenue with no limit. The KLC has also entered into a long term contract with a vendor to provide production, broadcast network management, and distribution of nightly drawing shows on a statewide radio and television network. This contract expires in September 2009. The total amount to be paid on the contract shall not exceed $2.4 million.

REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS

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An Independently Owned Member of the RSM McGladrey Network

To the Auditor of Public Accounts,
Commonwealth of Kentucky, and
the Board of Directors of the
Kentucky Lottery Corporation

We have audited the financial statements of the Kentucky Lottery Corporation (the KLC) as of and for the year ended June 30, 2006, and we have issued our report thereon dated August 2, 2006. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control over Financial Reporting

In planning and performing our audit, we considered the KLC's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be material weaknesses. A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS (CONTINUED)

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the KLC's financial statements are free of material misstatement, we performed tests of compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of non-compliance or other matters that are required to be reported under *Government Auditing Standards*.

We noted certain matters that we reported to management of the KLC in a separate letter dated August 2, 2006.

This report is intended solely for the information and use of the audit committee, management of the KLC and the Auditor of Public Accounts of the Commonwealth of Kentucky and is not intended to be and should not be used by anyone other than these specified parties.

Harding, Shymanski & Company, P.S.C.

Louisville, Kentucky
August 2, 2006

Schedule of auditor's results

We have issued an unqualified opinion, dated, August 2, 2006, on the financial statements of the KLC as of and for the year ended June 30, 2006.

Our audit disclosed no instances of noncompliance which are material to the KLC's financial statements.

Findings relating to the financial statements

Our audit disclosed no findings which are required to be reported in accordance with *Government Auditing Standards*.

SCHEDULE OF PRIOR AUDIT FINDINGS AND THEIR RESOLUTIONS
Year Ended June 30, 2005

The prior year's audit disclosed no findings which are required to be reported in accordance with *Government Auditing Standards*.